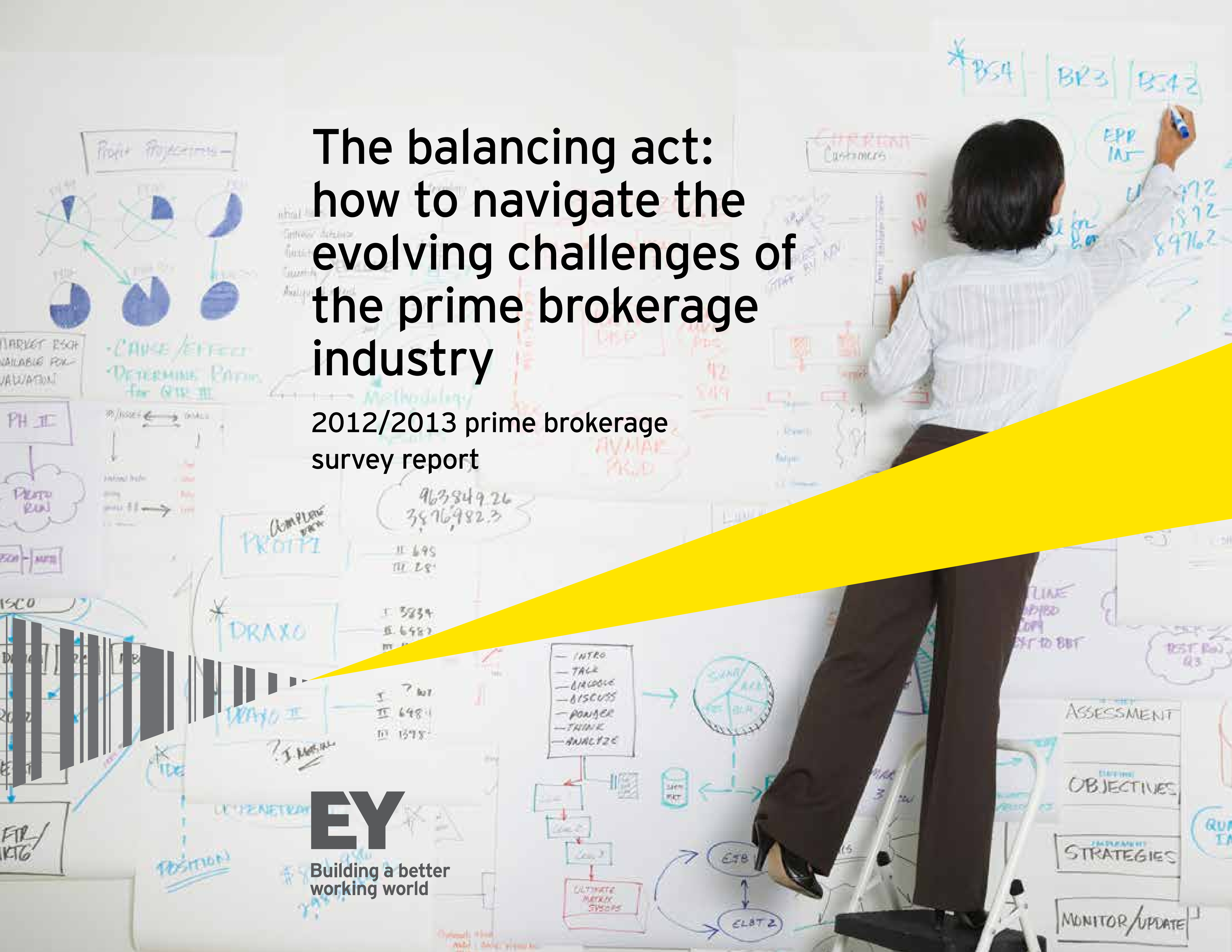
The balancing act: how to navigate the evolving challenges of the prime brokerage industry

2012/2013 prime brokerage survey report



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The prime brokerage industry today is facing crucial challenges brought on by the shifting composition of the hedge fund industry and the changing regulatory requirements for banks and dealers.

These factors have combined to put pressure on prime broker revenues, despite the fact that the hedge fund industry's current US$2.4 trillion[1] assets under management (AUM) have exceeded the US$1.95 trillion pre-crisis level.[2]

In response, leading prime brokers are attempting to differentiate themselves through unique product offerings and their ability to leverage proprietary technologies and organizational efficiencies, as well as detailed client analyses. These are the key takeaways from EY's 2012 Prime Brokerage Survey.

Elusive revenues

Pressure on fees and the multi-prime trend in the prime brokerage industry are slowing the industry's full recovery from the depths of the recession. Global prime brokerage revenues in 2012 were estimated at $12 billion, down from $15 billion in 2008.[3] Because there are more active firms gathering market share today, revenues at individual firms may have decreased more than the aggregate figure suggests.

Hedge funds are continuing to diversify their prime broker exposure in order to reduce their counterparty risk. The collapse of several firms during the financial crisis, which accounted for a large share of the prime brokerage business, demonstrated the need for funds to spread their risk. In 2006, the top two prime brokers, Goldman Sachs and Morgan Stanley, accounted for 52% of hedge fund assets. In 2012, they accounted for less than 33%.[4] Medium-size prime brokers have been the beneficiaries as hedge funds diversified away from the giants, and international firms such as Deutsche Bank and Credit Suisse have made large inroads in the Americas.

While the multi-prime approach appears to be here to stay, funds have regained confidence in their brokers' ability to provide leverage as the banking industry has recovered. Funds also want to reduce the administrative costs and complications of maintaining relationships with multiple firms. These factors are leading to a steady reduction in the average number of prime relationships per fund since the downturn. In 2009, hedge funds with more than $3 billion in assets had an average of 4.8 prime brokers, according to Tabb Group. Funds typically had only one broker before the crisis. But that disaggregation is reversing, falling to 3.9 brokers in 2010 and to 2.9 brokers in 2011.[5]

On the other hand, there are two factors promoting the need for multi-prime relationships which cannot be ignored: first, higher capital mandates for over-the-counter (OTC) derivatives will limit the amount of OTC derivatives business one prime broker can conduct. Second, there has been a shift in the relative popularity of hedge fund strategies since the financial crisis. In 2011, multi-strategy funds accounted for nearly one-third (32%) of North American AUM, double the pre-crisis level.[6] This type of fund requires a broad range of prime brokerage services and access to markets, which often cannot be provided by one firm. Prime brokers that can provide multi-market access and can help funds optimize their capital via margin netting and collateral management have a competitive advantage.

Another challenge facing the industry is that the contraction of the financial services industry overall has placed cost pressures on prime brokers. Firms hoping to add clients, but reduce costs by leveraging efficiencies and economies of scale, still find this difficult to achieve because of the large amount of transaction customization and client relationship management required in the business.

Boosting profitability

The prerequisite for creating a business model to respond to these trends is a strong understanding of the profitability of clients. This is an area where prime brokers have seen some difficulty. Although revenues are straightforward to calculate, determining the operational costs per client — onboarding, fails, risk management, monitoring and compliance — remains less so. The industry is focusing on how to better quantify operational costs in order to increase the profitability margins of new and current clients.

When prime brokers develop a better understanding of the profitability of each client, they can create effective tiering models based on profitability instead of revenues and develop concrete guidelines for when to renegotiate pricing, offer more services or restrict them. Prime brokers are leveraging technology to accomplish some of this, such as tracking the client onboarding process. But our survey revealed that prime brokers do not yet have the ability to integrate all their systems with clients' information and unique business requirements, nor the ability to quantify fails information and their associated operational costs. Until they do, understanding client costs and ultimately, profitability will remain difficult.

Survey methodology

EY surveyed executives from eight leading prime brokers in 2012. Each prime broker was a part of a global bank or a large financial institution with a global footprint. Their organizational structures varied, but each firm did have dedicated individuals within its middle and back offices that supported the prime brokerage operations.

The survey covered a variety of topics, including organizational structure, new business (including pricing and lockup agreements), client monitoring and revenue management as it relates to securities lending.

[1] "HFR Global Hedge Fund Industry Report — Second Quarter 2013," *HFR*, www.hedgefundresearch.com, 18 July 2013.

[2] "Global Hedge Fund Key Trends," *Eurekahedge*, www.eurekahedge.com, March 2011 and March 2012.

[3] Edward Krudy, "Prime brokerages consolidate after 'big bang'," *Reuters*, www.reuters.com, 16 April 2013.

[4] "Global Hedge Fund Key Trends," *Eurekahedge*, www.eurekahedge.com, March 2011 and March 2012.

[5] Edward Krudy, "Prime brokerages consolidate after 'big bang'," *Reuters*, www.reuters.com, 16 April 2013.

[6] "Global Hedge Fund Key Trends," *Eurekahedge*, www.eurekahedge.com, March 2011 and March 2012.

Key findings

1. Client acceptance

Our survey found that most brokers have a formal acceptance process for new clients. Seventy percent have an acceptance committee – commonly comprised of representatives from sales, account management, legal, operations and risk – that determines whether or not to take on a new client. The other 30% of brokers have an informal process involving a small group of individuals from senior management.

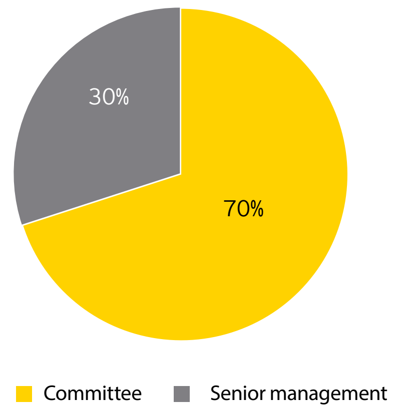
Most firms take the same steps when considering a new client. A pre-qualification and verbal agreement is followed by due diligence and approval by the acceptance committee or the senior management group.

Evaluation criteria are also similar across the board. Prime brokers request financials, audited if possible, and sample portfolios to stress test. They review the portfolio, management team, the fund's cash and debt service, and its strategy.

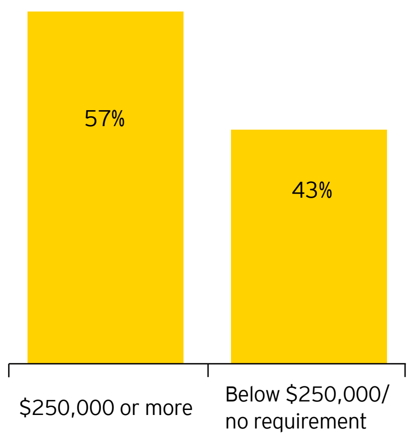
Fifty-seven percent of the prime brokers surveyed have minimum revenue per annum requirements starting at $250,000, while the rest will make exceptions below that. Several top firms use tiers to set pricing for each client; others may follow suit.

Given the range of hedge fund strategies, client acceptance requires a significant amount of judgment and does not present much opportunity to find efficiencies. However, firms that begin by gaining a better understanding of the potential operational cost of a client under consideration will be best placed to decide whether the relationship will be profitable over the long term.

Method for new client approval



Revenue requirement



2. Client onboarding and monitoring

The Securities Investor Protection Act of 1970 sets certain standards for prime broker risk management, including the need to undertake stringent client due diligence when initiating new relationships and to frequently assess client financials to evaluate risk. Most prime brokers do much more than is required by law. Their ability to do it efficiently would be improved greatly through a comprehensive client onboarding and monitoring system.

The survey shows that prime brokers can potentially gain advantages by introducing better technology into the onboarding process. Less than half — 44% — of firms use a semi-automated process for capturing data and tracking onboarding progress and completion. All of these tools are proprietary, and all are limited to tracking onboarding. None of the firms surveyed had a tool that configures and integrates all prime brokerage systems with client information and unique business requirements, meaning no firm is able to fully automate client set-up.

When clients are on board, all of the prime brokers monitor them on a daily basis for risk and profitability. Three-quarters also have scheduled meetings weekly, monthly or quarterly to review client activity and risk. The remaining 25% meet with clients on an ad-hoc basis. Both those that hold scheduled meetings and those that take an ad-hoc approach raise concerns with fund managers as soon as they arise, rather than waiting for a meeting.

44% of firms use an automated workflow tool

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Of the 44%, all firms use a proprietary tool

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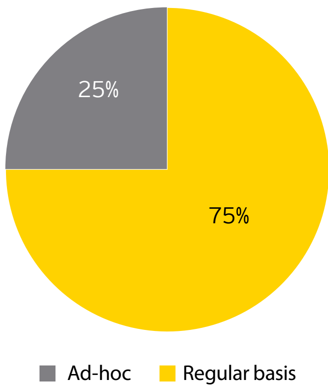
No firms are able to fully automate client setup

Client monitoring through scheduled meetings



3. Organizational structure

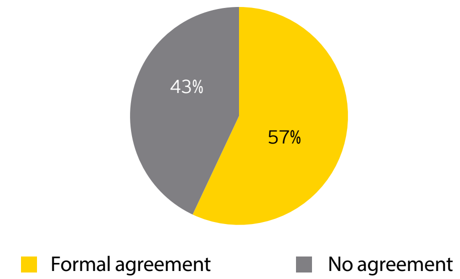
Only one prime broker surveyed separates itself as a standalone, separate and distinct business unit. The others work in the same silos that affect the business, such as securities lending, FX and OTC clearing. Securities lending desks usually report to prime brokerage, but serve other businesses as well. All the prime brokers have dedicated sales and account management teams.

Back-office, support (IT) and risk functions range in structure from a centralized model that is not specific to prime brokerage to a dedicated model that is. In most cases, a prime broker's risk functions report directly to a CRO that is outside of the brokerage.

While a majority (57%) of the brokers surveyed have service-level agreements between centralized back-office support and prime business lines, there seems to be no one-size-fits-all approach to how the middle office is structured and how it functions. Prime brokers use varying tactics for performing work such as P&L generation, confirmation and affirmation, and reconciliation.

All the survey participants said they use a broker/dealer structure, combined with an offshore entity, such as a UK broker/dealer or another international entity. This structure allows the prime brokers to move their derivatives business offshore, reducing their balance sheet burden and lowering regulatory capital.

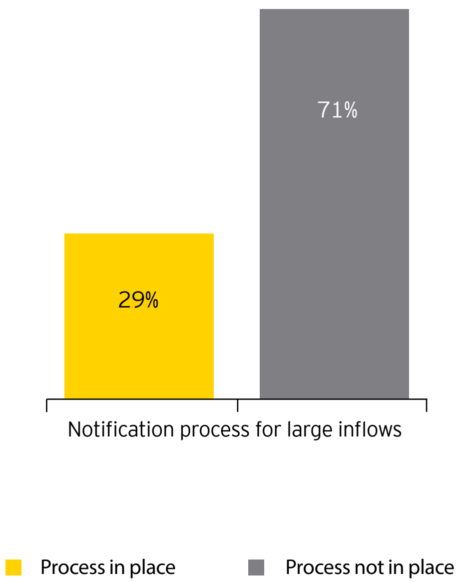
Service-level agreements between back office and prime broker business lines



4. Liquidity management

Liquidity management is an area that could benefit from better data management processes and technology. The biggest prime brokers are part of larger banks and financial services firms, of course, meaning they can obtain capital inexpensively and achieve the ability to withstand large cash fluctuations. Still, 71% of the prime brokers surveyed do not have a method for notifying their treasury group of large cash inflows and outflows. The 29% that do, use email and phone calls to inform treasury. However, the prime brokers do speak with their clients about the best times for cash deposits and how funds expect the prime broker to help to manage their liquidity needs. Incidentally, all brokers admitted they would not refuse a cash deposit.

Large inflows



5. Revenue allocation

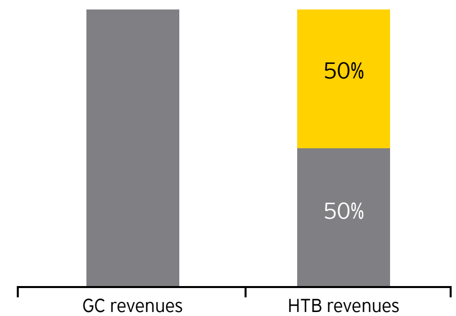
Our survey showed that there is no standard way that prime brokers allocate revenue between Securities Finance and other groups. Firms usually split revenues between the securities lending desk and the source of the long. The thought process behind the revenue allocation model used describes the tension involved in the business: do you reward the lending desk that generates the actual revenue by finding the counterparty looking to borrow securities? Or do you reward the desk that provides the security in the first place? While our survey respondents agreed on no standard way, two prevalent models were identified. In one, hard-to-borrow (HTB) revenues were split between the desk providing the long and the desk providing the short, with the securities lending desk receiving all general collateral (GC)-related revenue. In the other, HTB revenues were given to the desk providing the long, and GC revenue was split between both desks. However, securities lending desks usually retained all of the revenues from conduit business.

The survey also found that collateral agreements are usually written into the prime brokerage agreement. However, hard-to-borrow securities require collateral negotiation on a case-by-case basis.

Firms apply different models for allocating revenue between channels providing security supply (long) and demand (short). The approach is different for GC provided through the margin box vs. HTB securities.

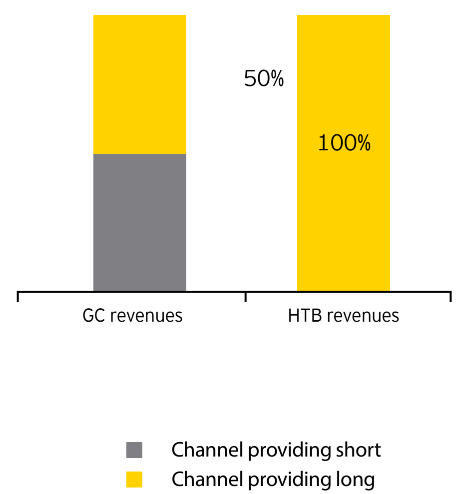
Model I

Per one model, GC revenues are kept with the channel providing the short, while HTB revenues are negotiated between the channels with a default 50:50 split.



Model II

Per another model, HTB revenues are kept with the channel providing the long, whereas GC revenues are split 50:50.



6. Lockup agreements

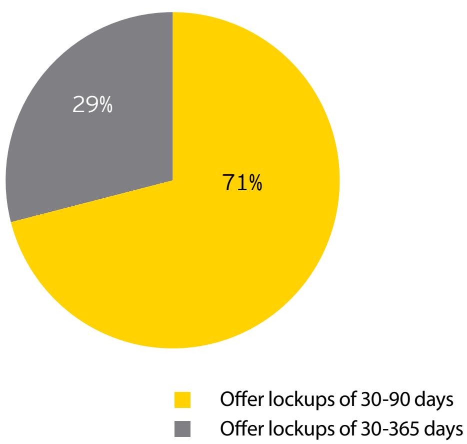
More than 70% of the firms surveyed offer lockup agreements. The most popular terms are 30, 60 and 90 days. About 30% of the survey respondents provide lockups as long as 365 days, depending on the client and relationship. Larger firms are more willing to grant longer lockups, such as 60 days and 90 days.

If a hedge fund has illiquid positions that would necessitate a prolonged period to duplicate positions with another prime broker, the survey respondents said they typically grant the client a longer lockup (beyond 90 days, for example).

The lockup agreements represent considerable risk to the prime brokers. Therefore, all the firms include language in their agreements to hedge the risk. These clauses address missed margin calls, minimum net equity and asset values. Some firms have written dynamic lockup agreements that take into account market behavior.

Prime brokers use both centralized and decentralized approaches to monitoring lockups. In the former, the firm has dedicated groups monitoring adherence to the agreement. With the latter, there are usually multiple groups, each monitoring a different lockup requirement.

Lockup agreement terms



7. Enhanced leverage

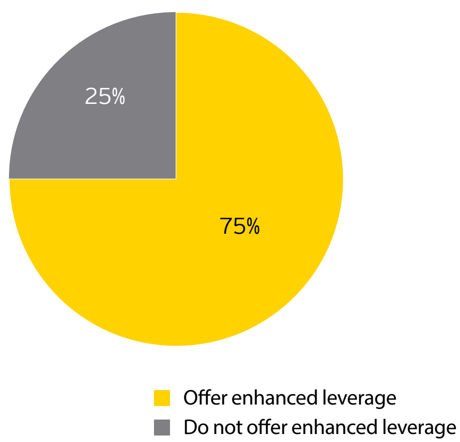
Three-quarters of the survey respondents offer margin relief to their clients beyond the Federal Reserve's Regulation T margin limit of 50%. This is through enhanced leverage and portfolio margining. Some of the other firms only offer portfolio margining.

Enhanced leverage levels of 6:1 and higher are possible for large and healthy hedge funds. However, regulators may look askance at prime brokers who push the envelope.

There was no consensus among the survey respondents regarding who should monitor the non-cash collateral provided in an enhanced leverage transaction. Rehypothecating some of the collateral can improve the risk-return trade off of the transaction, although prime brokers do need the client's permission.

However, opportunities for rehypothecation are limited by an SEC rule that requires a broker-dealer to maintain physical possession and control of fully paid and excess margin securities.

Enhanced leverage offering



Product perspectives

The survey revealed some interesting trends around how prime brokers manage some notable products.

ETFs: Some brokers perform all ETF creation work in-house, while others use both internal and external inventory (box and/or borrow) for this. In most firms, the Delta One desk manages the creation of the ETF — either for the firm or for a customer — creating supply to cover the short.

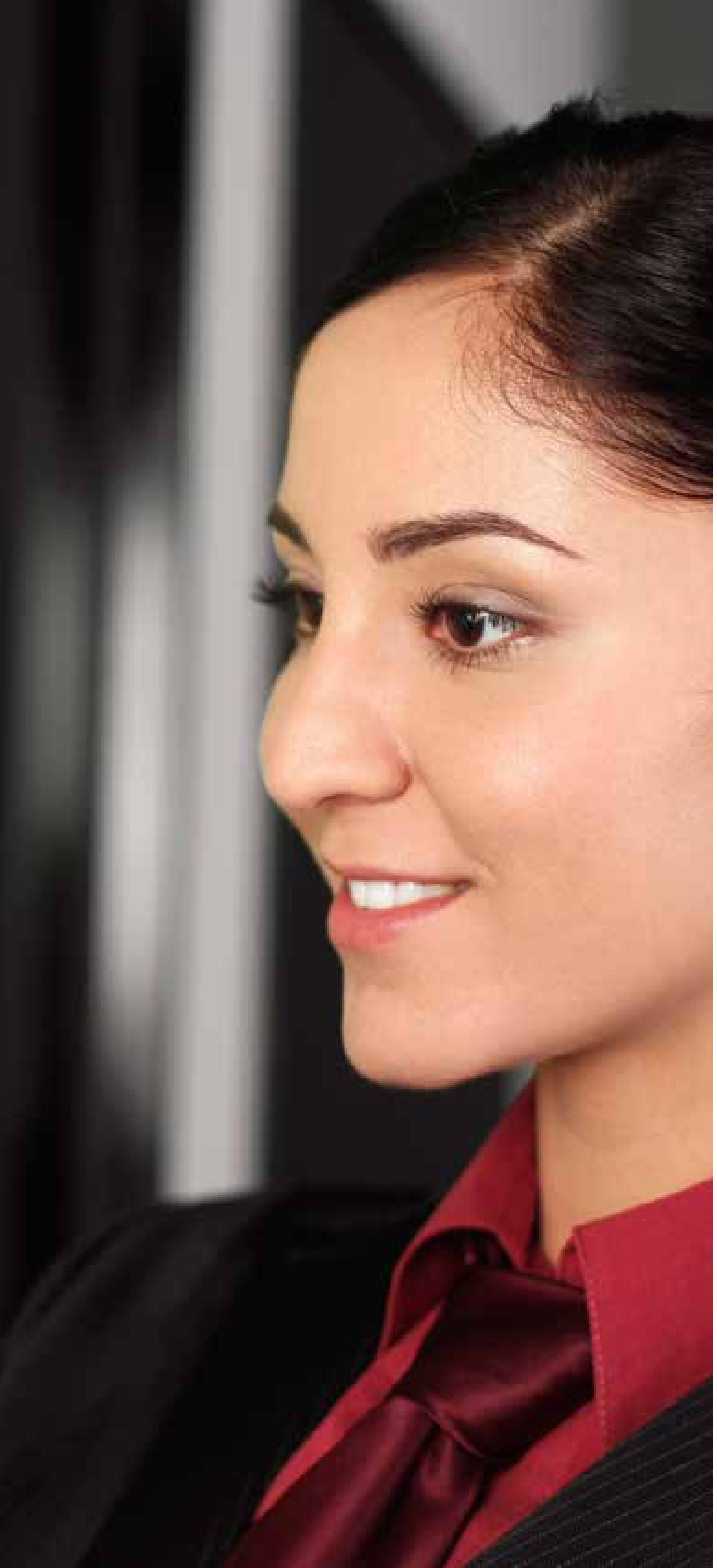
Equity reverse repos: No brokers surveyed use equity reverse repos. They are worried about customers and regulators forming negative perceptions if they appear to purposely try to reduce customer lockup periods.

Single stock swaps: If such a swap is recorded by the broker-dealer, prime brokers appeal to regulators to allow the swap to be included in their risk-based haircut model. This approach offers relief from capital charges. Most brokers use an affiliate to conduct such swaps in this manner. The prime broker swaps the stock with the affiliate. The swaps are not booked on the US-based broker-dealer, but the broker-dealer is provided use of it.

Stock-for-stock transactions: Some prime brokers surveyed admitted that they do few stock-for-stock transactions because they prefer stock-for-cash deals for funding purposes. All survey respondents account for these transactions by grossing up the balance sheet whether they are the borrower or lender. For this reason, prime brokers generally do not perform analyses of the "inflation" of these trades.

Fully-paid-for programs: These programs are scarce among prime brokers. All of those surveyed said that these programs were not important to their business – only 10% of their customers participate — and are mainly used for hard-to-borrow securities.

Tri-party structures: All the brokers surveyed utilize tri-party structures. Repo tri-party is used for funding, while they also employ tri-party structures with certain hedge fund clients that have a broker-dealer.



Final thoughts

Cost cutting, tighter capital and leverage requirements, more demanding clients and the paucity of client profitability measures are all real challenges for prime brokers that want to respond effectively to changes in the hedge fund industry.

To meet these challenges requires prime brokers to be able to ascertain each client relationship's profitability. For this, they need an understanding of the cost of the operational services that the broker provides the client. This understanding will allow a firm to tier its clients effectively, thereby choosing the most appropriate fee to charge. In the current environment, the balancing act requires building and maintaining a relationship of quality based on trust with every client, while reducing capital risk for the firm, key elements in achieving long-term success.

Contacts

New York

Mark DiMaio
Principal — Banking & Capital Markets
+1 212 773 8587
mark.dimaio@ey.com

John M. Keller
Partner and Global Banking and Capital Markets Advisory Leader
+1 212 773 2049
john.keller@ey.com

Arthur F. Tully
Partner and Co-leader, Global Hedge Fund practice
+1 212 773 2252
arthur.tully@ey.com

London

Alex Birkin
Partner and Global Asset Management Advisory Leader
+44 20 7951 17 51
abirkin@uk.ey.com

We appreciate the contributions to the article by Mark DiMaio, Nagaraj Swaminathan, Allan Chu, David Weisberg, Megan Duffy and Myriam Barthes, all with Ernst & Young LLP.

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EYG no. EH0114
BSC no. 1311-1169117

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